Fordham Urban Law Journal

Volume 9 | Number 2 Article 7

1981

The GNMA Securities Market: An Analysis of Proposals for a Regulatory Scheme

Janice L. D'Arrigo

THE GNMA SECURITIES MARKET: AN ANALYSIS OF PROPOSALS FOR A REGULATORY SCHEME

I. Introduction

In the mid-1960's, efforts to increase and stabilize the supply of residential mortgage credit to attract a broader base of investors and capture a portion of the financial resources traditionally invested in the security and bond markets led to the development of the Government National Mortgage Association Mortgage-Backed Securities ("MBS") program. In 1968 Congress created the Government National Mortgage Association ("GNMA" or Ginnie Maė) through an amendment to Title III of the National Housing Act.[1] GNMA exists as a corporate instrumentality within the Department of Housing and Urban Development ("HUD") whose purpose it is to assume certain functions of the Federal National Mortgage Association ("FNMA") which could not be carried out in the private market.[2] The Housing and Urban Development Act of 1968[3] amended the National Housing Act[4] by adding section 306(g) which authorized GNMA to guarantee timely payment of principal and interest (plus prepayment and foreclosure proceeds) on securities backed by a trust or pool of qualifying mortgages.[5] GNMA's guaranty is backed by the full faith and credit of the United States Government.[6] The first series of GNMA-MBS[7] was issued in Feb-

---

1. National Housing Act of 1934, Pub. L. No. 90-448, § 802, 82 Stat. 476 (1968) (codified at 12 U.S.Ç. § 1717(a)(2)(A) (1976)).

2. There are presently two major GNMA programs. One is the purchase of mortgages to support housing for low-income families for which private financing is not readily available. The second major GNMA activity is its mortgage-backed securities program which has revolutionized the secondary mortgage market. *See* S. REP. No. 91-392, 91st Cong., 1st Sess. *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 1524, 1533.

3. *See* 24 C.F.R. § 300.5 (1978).

4. *See* 12 U.S.C. §§ 1716-1723 (1976).

5. The GNMA guarantees timely payment of principal and interest on securities based on pools of government-underwritten mortgages and issued by private institutions, i.e. securities collateralized by single-family, third year mortgages on one-to-one-unit dwellings. U.S. DEPT. OF HOUSING AND URBAN DEVELOPMENT, *Analysis and Report on Alternative Approaches to Regulating the Trading of GNMA Securities* 3 (1978) [hereinafter cited as HUD Report].

6. Accordingly, GNMA securities attract investors because they are considered highly reliable. On the other hand, problems related to GNMA securities could cause a "ripple

ruary 1970. To date, the total amount of Ginnie Maes issued is approaching $100 billion; approximately one quarter of this aggregate amount has been issued in the past year.[8] As a result of this ability to attract an increasing volume of non-traditional investors into the residential mortgage market, the GNMA-MBS program has aided in reducing the effect of cyclical fluctuations in the housing market and has tended to hold down mortgage interest rates.

Thus, the emergence of mortgage-backed, modified pass through securities guaranteed by the Government National Mortgage Association has significantly improved the acceptance of mortgages as an investment vehicle.

Presently, Ginnie Maes and transactions in the markets on which they are traded are not regulated under the federal securities laws. As a result, trading abuses in the Ginnie Mae forward market have arisen, posing a potentially serious risk to the entire securities industry. If abuses in this market were to cause investors to avoid the risk associated with trading in GNMA securities, the impact on the availability of capital for housing would be most serious. This Note will first explore the nature and scope of the GNMA Securities market, and second, will discuss the legislative framework for the overlapping jurisdiction of the Securities and Exchange Commission ("SEC") and the Commodities Futures Trading Commission ("CFTC") over GNMA industry regulation. In addition, this Note will highlight the evolution of alternative regulatory responses of various government agencies, including the CFTC and SEC, as well as the industry's proposals for self regula-

---

effect" that would spread to other kinds of U.S. securities and interfere with the finances of the nation.

7. Throughout this Note the term "Ginnie Mae" will refer to the "modified pass through" type securities guaranteed by the GNMA. This means that GNMA guarantees that the holders of the securities will receive their respective shares of the regular monthly principal and interest payment which are due and owing on the underlying mortgages, even if the mortgage payments are in fact delinquent or the issuer fails to permit the payments to the holders. All additional payments resulting from foreclosures or prepayments are also passed through to holders immediately. *See* Boileau, *GNMA Pass Through: Overwhelming Success Story*, 37 MORTGAGE BANKER 20 (1977).

8. Through the mortgage-backed securities program, it is estimated that financing has been provided for nearly three million home purchases. GNMA estimates that more than nine million Americans have lived in homes financed through the mortgage-backed securities program. Moreover, the GNMA program has been so successful in housing finance, that it is setting the pattern for the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, and privately-issued mortgage-backed securities. *Id.*

tion. Finally, in light of the fact that a comprehensive governmental regulatory pattern would require legislation, this Note reviews the proposed legislation introduced on April 1, 1980 by Senator Harrison Williams, Chairman of the Housing and Urban Affairs Subcommittee to amend the Securities and Exchange Act of 1934. This Note further reports on the proposals recently formulated by a joint regulatory study of the government securities market undertaken by the Treasury Department, Federal Reserve Board, and SEC.

II. Nature and Scope of GNMA Securities Market

Pursuant to the 1968 HUD Act, GNMA's major functions may be categorized generally as follows. First, under its management and liquidating function, GNMA manages portfolios of federally-owned mortgages originated by the Federal National Mortgage Association.[9] GNMA's second principal activity is its special assistance function carried out through its mortgage purchase or "tandem" programs. Under these programs, GNMA assists the housing industry through commitments to mortgage lenders in times of tight money. Accordingly, GNMA purchases certain types of Federal Housing Administration, Veteran Administration and conventional mortgages in fulfillment of its statutory objectives to provide support for the types of housing for which financing is scarce, such as housing for low-income families, and to reverse declines in mortgage lending and housing construction.[10] Third, under its guaranty function, GNMA operates the MBS program.[11]

Specifically, each GNMA certificate represents a pro-rata share in a pool of mortgages insured by the Federal Housing Authority ("FHA") or the Farmers Home Administration ("FmHA") or guaranteed by the Veterans Administration ("VA").[12] The mortgages in a pool must all bear uniform interest rates and must have approximately the same date of maturity. Certificates are issued in an aggregate principal amount equal to the total unpaid principal bal-

9. *See* 24 C.F.R. § 300.5 (1978).

10. In 1974, Congress authorized GNMA to operate a tandem plan for conventional (non-FHA/VA) mortgages. National Housing Act of 1934, § 313, 12 U.S.C § 1723(e) (1976), added by Emergency Home Purchase Assistance Act of 1974 § 3, Pub. L. No. 93-449, § 3(a), 88 Stat. 1364 (1974).

11. *See* 12 U.S.C. § 1721(g) (1976).

12. HUD Report, *supra* note 5, at 4.

ances of mortgages in the pool.[13] Moreover, ownership of these securities, which are fully transferable, is registered by GNMA in accordance with Treasury Department regulations.[14] Mortgages in a pool of one-family mortgages are for thirty years.[15]

GNMA certificates constitute "securities" within the meaning of section 2(1) of the Securities Act of 1933 (the "1933 Act")[16] and section 3(a)(1) of the Securities Exchange Act of 1934 (the "1934 Act").[17] GNMA securities are exempt from the registration requirements of the 1933 Act under section 3(a)(12) which exempts "any security issued or guaranteed by the United States . . . or any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by Congress.[18] However, section 3(a)(12) of the 1934

13. The interest rates of the certificates are fixed at 0.5% below the interest rate of the pooled mortgages. The differential is applied to the originators' servicing fees and GNMA's guaranty fee. *Id.*

14. HUD Report, *supra* note 5, at 5. Certificates bearing the same interest rate are fully fungible because of GNMA's pool composition requirements and because pooled mortgages have similar amortization schedules. The mortgages themselves are transferred to a bank or trust company to hold as a custodian. In the event of default in payment by the issuer of securities, the mortgages are transferred to GNMA, which may then place them with another lender to manage and service. Reflecting an extremely active secondary market, $41.9 billion of securities were transferred among registered holders during the fiscal year 1979, an average of greater than $3 billion per month. It is reported that often dealers trade in the secondary market without formal re-registration. Further, the number of active issuers at the end of the fiscal year 1979 was 843, up 125 from the prior year. GNMA, *Annual Report* 6 (1979).

15. The great majority of securities issued have been collateralized by single family mortgages, but multi-family project and mobile home loans have also been used. As of fiscal year 1979, $22 billion mortgage-backed securities were guaranteed by GNMA. Constituting the greatest amount ever guaranteed in a single year, the cumulative program rose to $84.5 billion according to the GNMA statistical breakdown of this total. $79.6 billion is in single-family (level payment) securities, $2.8 billion in project and construction loan securities, $1 billion in the newly graduated payment securities, and $943 million in mobile home securities. *Id.*

Since experience has shown that they pay down faster, yield is often calculated as though the certificates were to be paid on a regular monthly basis of principal and interest for twelve years, with the remaining balance being paid off at the end of the 12th year. However, a pool may pay down faster or slower than this assumption. Speed of payment affects the yield of the certificate.

16. 15 U.S.C. § 77b(1) (1976).

17. 15 U.S.C. § 77c(a)(12) (1976).

18. 15 U.S.C. § 77c(a)(2) (1976). Under the 1933 Act, Ginnie Maes are exempted from § 5 registration requirements. 15 U.S.C. § 77f (1976). Issuers of Ginnie Maes are not required to adhere to the formalities of registration with the SEC prior to public offering nor to

Act also provides an exemption for U.S. guaranteed securities.[19] Therefore, securities dealers who deal solely in Ginnie Maes and other exempt securities need not register with the SEC. GNMA securities are also exempt from the margin rules, for example, Regulation T of the Federal Reserve Board.[20] Certain provisions of federal securities law, notably the general antifraud provisions, are applicable to any transactions in Ginnie Maes. GNMA securities are not exempt from the anti-fraud rules of section 17(a)[21] and section 10(b) of the 1934 Act.[22]

GNMA securities are traded primarily over-the-counter by securities dealers. Initially, GNMA purchasers were banks and sav-

---

deliver a statutory prospectus to purchasers. Thus, an issuer is not subject to § 11 civil liability arising from misstatements or omissions in a registration statement. 15 U.S.C. § 77l (1976).

Further, Ginnie Maes are exempted from the § 12(2) anti-fraud provisions, 15 U.S.C. § 77q(c) (1976). Thus, one who sells securities by means of untrue or misleading statements is not subject to civil liability to the purchaser under this section of the Act.

19. 15 U.S.C. § 78c(a)(12) (1976).

20. 15 U.S.C. § 78g-h (1976). Section 7 authorizes the Federal Reserve Board to limit the amount of credit that may be extended on securities, specifically excluding exempted securities. Generally, the term margin refers to a deposit of cash or collateral by a client with his broker (or by a broker with his clearinghouse) which provides a measure of protection to the broker (or clearinghouse) in the event of adverse price movement on an open position coupled with a default by the client (or broker). Margin in commodities is not a payment for equity or down payment on the commodity itself but rather is in the nature of a performance bond or security deposit. The difference is significant because (a) both buyer and seller post margin in commodities; (b) the remainder of the position is not being borrowed from one's broker and does not require interest payments; and, (c) as price moves against one's position, the account is debited and the protection represented by the initial margin may fall below the prescribed maintenance level, in which case the trader will be required to post additional margin. HUD Report, *supra* note 5, at 209.

21. 15 U.S.C. § 77q (1976). Under § 17, dealers who offer or sell Ginnie Maes by means of fraudulent or untrue statements may be enjoined. Unless the courts implied the existence of a private right of action for violation of § 17, only injunctive relief and criminal sanctions are available. Criminal sanctions are provided for under § 24 of the Act, 15 U.S.C. § 77x (1976).

22. 17 C.F.R. § 240, 10b-5 (1980). Section 10b-5 makes it unlawful to engage in fraudulent or deceptive acts or practices, or to make any untrue or misleading statements, in connection with any purchase or sale of any security. *See* G.A. Thompson and Co. v. Wendell J. Miller Mortgage Co., FED. SEC. L. REP. (CCH) ¶ 95,668 (S.D.N.Y. 1976) (private action); In re Merrill Lynch, Sec. Ex. Act Rel. No. 11515, FED. SEC. L. REP. (CCH) ¶ 80,216 (1975).

The courts have recognized an implied private right of action under Rule 10b-5 for one who purchases or sells securities and suffers damage as a result of a violation of the rule. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). However, the requirement of scienter in a 10b-5 action since Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) has diminished the probability of recovery in such actions.

ings and loan associations. Ginnie Maes were an attractive investment for these institutional purchasers, in part because Ginnie Maes qualify as real estate assets and thus can be used by thrift institutions to meet those real estate requirements which allow special tax benefits. While banks and savings and loans associations remain the largest investors, there has been a significant increase in credit union and pension and retirement fund participation[23] as well as the development of mutual funds for individual investors.[24]

Issuers of GNMA securities are predominantly mortgage bankers.[25] A mortgage banker originates mortgages primarily to establish a mortgage-servicing portfolio; he generally does not speculate on interest rate shifts. Rather, he seeks to guarantee, at known terms, his commitment to provide funds for the mortgages he plans to acquire. A mortgage banker typically hedges against possible changes in interest rates by selling either mortgages or Ginnie Maes for delayed delivery.[26] A mortgage banker may not have

---

23. HUD Report, *supra* note 5, at 64.

24. These securities are attractive to investors with monthly cash flow needs. Ginnie Maes are more palatable to investors than mortgages because they require no effort on the part of the investor to search title, appraise value, establish creditworthiness, or deal with other factors about which a direct investor in mortgages is normally concerned. G. OSBORNE, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW 666 (1979).

25. HUD Report, *supra* note 5, at 8. In order to issue GNMA securities, the issuer must first assemble the underlying pool. Only newly issued mortgages qualify for use in a GNMA pool.

26. *Id.* at 28-29. Hedging involves

> two or more contemporaneous transactions in which the same or similar securities or commodities in which the risk of price movement is believed by the initiator (hedger) to be reduced or changed. Hedging is common in futures, forward, and options trading strategies. A typical hedge might be for a speculator or investor to buy a security for delivery three months away at a specified price and to sell the same security at another price for forward delivery six months away. The investor who makes such a transaction believes that the shorter or nearby contract will rise in price more rapidly than the longer contract. His potential profit is the difference in the prices from his original, or opening, transactions and his final, or closing, transactions. Other typical hedges are taking an opposite position in the futures market to a position held in the cash market to minimize the risk from adverse price changes, and taking a position in the futures market as a temporary substitute for a cash transaction that will occur later. Another type of hedge is for the producer of a commodity such as a mortgage banker (who 'produces' mortgages which will be converted into Ginnie Mae pass through securities) to make financial commitments to the mortgagee now and guarantee a profit on the transaction by selling contracts to deliver Ginnie Mae pass through securities at a future date when they become available.

originated the mortgages being sold, because he may be unwilling or unable to advance capital without assurance of a ready market.[27] Therefore, he sells to a dealer on a delayed-delivery basis Ginnie Maes he reasonably intends to originate.[28] A contract for delayed delivery of Ginnie Maes constitutes a negotiated cash market transaction in which two parties agree to the terms by which they purchase and sell Ginnie Maes which are to be delivered at an agreed future date. Such a contract is known as a delayed-delivery or a forward contract.[29]

In the Ginnie Mae forward market, the dealer promptly resells the Ginnie Maes which he has purchased to his customer shortly after the dealer anticipates delivery from the mortgage banker.[30] The delayed-delivery contract assures the mortgage banker of maximum flexibility. It is an aid in keeping interest rates down and an encouragement to the mortgage banker's increased participation in the GNMA market.[31]

III. SEC/CFTC Overlapping Jurisdiction

The nature of the investment and general trading practices have given rise to the GNMA futures market as well as the previously

---

Id. at 208.

27. *Id.* at 30.

28. Due to building schedules and paperwork involved in creating Ginnie Maes, the process may take from 90 to 120 days to develop a mortgage pool and arrange for GNMA guaranty. *Id.* at 10.

29. *Id.* at 206. A forward contract may also be referred to as a "TBA," i.e., to be announced, because certain details of the certificate are not known at the time of the sale. *Id.* at 14. GNMA forward contracts must be distinguished from GNMA futures contracts, which are standardized commodities contracts traded on a Board of Trade. In contrast to futures contracts, forward contracts are not traded on organized exchanges, generally do not require margin payments, and can only be terminated by agreement of both parties to the transaction. The fact that trading in the forward market, unlike the futures market, may be accomplished without margin payment, gives rise to the ability of a mortgage banker, dealer, investor or speculator to hedge, invest, or speculate without putting up any "front" capital. Thus, trading abuses occur in the Ginnie Mae forward market.

30. *Id.* at 28-32. It should be noted that the dealer's customer acquires no rights against the mortgage banker. Under the terms of the purchase agreements, at or before the delivery date, the mortgage banker may generally substitute securities with the same yield to maturity and with a dollar price no higher than par or may buy back the original commitment. A mortgage banker may wish to do this in order to obtain greater profit, either by selling actual mortgages to investors or by selling for more to GNMA under its standby commitment. *Id.* at 18.

31. *Id.* at 20.

described forward market.[32] GNMA futures contracts are traded on the Chicago Board of Trade and the AMEX Commodities Exchange.[33] Such contracts are within the definition of the term "commodity" in section 2(a)(1) of the Commodity Exchange Act which includes "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in."[34] The Commodity Futures Trading Commission ("CFTC") has exclusive jurisdiction over transactions involving contracts of sale of a commodity for future delivery traded or executed on a contract market.[35] The regulation of commodity futures, not government securities, is the primary function of the CFTC. However, section 2(1) of the 1933 Act defines the term "security" to include any right to purchase a security.[36] Because a GNMA futures contract is a right to purchase a GNMA security, arguably both agencies have jurisdiction over GNMA futures contracts.[37] This jurisdictional overlap was the subject of correspondence between the respective Chairmen of the SEC and CFTC in 1975.[38] In this correspondence it was noted that "if each agency follows its statute to its logical conclusion, the CFTC would govern aspects of the securities industry and the SEC would govern aspects of the commodity futures indus-

32. A futures contract is a contract traded on an organized exchange in which one party agrees to purchase and another to sell a specified security on a future date at a specified time. A contract for the future delivery of Ginnie Maes traded on the Chicago Board of Trade is defined as a futures contract. *See* FEDERAL RESERVE BOARD, PRELIMINARY EXAMINER QUESTIONNAIRE HUD Report, *supra* note 5, at Vol. II, 82.

33. *Id.* at 45.

34. Commodity Exchange Act of 1975, § 2(a)(1), 7 U.S.C. § 2 (1976).

35. *Id.* Section 2(a)(1) of the Commodity Exchange Act, as amended by section 201 of the Commodity Futures Trading Commission Act provides:

> That the [Commodity Futures Trading] Commission *shall have exclusive jurisdiction* with respect to accounts, agreements . . . and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 7 of this title. . . . (emphasis added).

7 U.S.C. § 2 (1975). Then, "except as hereinabove provided," that section goes on expressly to preserve the jurisdiction of the SEC as to other matters.

36. 15 U.S.C. § 77b(1) (1976).

37. With regard to the unambiguous jurisdictional domains of the CFTC and the SEC, "no one at the CFTC seems seriously to believe that [for example] the stock of General Motors or AT&T is the proper subject of a futures market, [nor would] anyone at the SEC . . . seriously argue that pork bellies or wheat is the proper subject for stock market activity." FED. SEC. L. REP. (CCH) ¶¶ 80,336, 85,871 (1975).

38. *Id.* ¶¶ 85,861-73. This jurisdictional overlap was also discussed in the congressional hearings relating to reauthorization of the CFTC in 1978.

try."[39] The concept of "concurrent jurisdiction" as it relates to areas which fall primarily within the domain of one or the other regulatory agency was rejected by both agencies on the grounds that it would lead to "duplication and inconsistency of regulation" as well as encroachments upon the exclusive jurisdiction provisions of the Commodity Exchange Act.[40] The CFTC has taken the position that "its responsibilities under the Act [are serious] and [the CFTC] is unwilling to concede the right of any other enforcement agency to do the job that Congress has expressly entrusted to the CFTC."[41] Accordingly, the SEC would have no right to "superimpose" securities law standards onto the CFTC's regulation of the future markets. However, in recognition of the SEC's "sensitivity" to issues raised by GNMA futures contracts on the Chicago Board of Trade,[42] the CFTC stated:

> notwithstanding its exclusive jurisdiction thereto, it [would] . . . consult with the SEC on all financial instrument items . . . sought to be traded on a futures contract market. . . . No theoretical strawman should be constructed to stand in the way of establishing and maintaining a cooperative spirit of understanding between the two agencies, nor in the way of the most effective utilization of each agency's resources and energies.[43]

An uneasy truce resulted, with the CFTC regulating futures contracts and the SEC bringing enforcement actions relating to activities in the underlying GNMA securities.

Generally, the CFTC has been more willing than the SEC to recognize industry regulatory initiative.[44] It is likely that the CFTC would assert jurisdiction over the elements of the markets for mortgage-backed securities which are the most significant for regulatory purposes. In *CFTC v. American Board of Trade, Inc.*,[45] the

39. *Id.* ¶ 85,871 (Supp. 1980).

40. Act of September 21, 1922, 42 Stat. 998, 7 U.S.C. § 1 (Supp. 1980), *as amended by* Act of October 23, 1974, Pub. L. No. 93-463, 88 Stat. 1389, and Act of September 30, 1978, Pub. L. No. 95-405, 92 Stat. 865.

41. FED. SEC. L. REP. (CCH) ¶¶ 80,336, 85,872 (1975)

42. *See* HUD Report, *supra* note 5, at 144-47.

43. 473 F. Supp. 1177 (S.D.N.Y. 1979).

44. *Id.* at 1182.

45. Judge Vincent L. Broderick concluded:

> An option involving any commodity is . . . a transaction in which one purchases or, in the case of the grantor, sells the right to enter into a transaction *in* that commodity - the right to purchase it or sell it, at a specified date and at a fixed price. The option transaction is a long step removed from a transaction *in* the commodity in-

CFTC alleged that the Commodity Exchange Act covered commodity options transactions based on spot and cash markets and transactions involving the sale of foreign currencies for future delivery, and that the Commission was entitled to a preliminary injunction against the defendants to prevent such unregistered parties from engaging in transactions in violation of the Act. The court held that transactions in options to purchase foreign currency are separate from transactions in foreign currency itself, and are, therefore, subject to CFTC regulation even though transactions in foreign currency are specifically excluded from the CFTC's jurisdiction.[46] Standby commitments to purchase mortgage-backed securities can be analogized to options and could, thereby, feasibly come under CFTC jurisdiction.[47]

Additionally, the CFTC may consider a general designation of forward contracts in GNMA securities as "leverage contracts" which would place them under the exclusive jurisdiction of the

---

> volved, since the option purchaser, if he or she does nothing more when the specified date arrives, will simply see the option die. If, when the exercise date arrives, the option holder decides to exercise the option, he or she at that point, and not before, will engage in a transaction in the commodity involved.
>
> In short, the Commodity Futures Trading . . . is authorized by the Commodity Exchange Act 'to regulate transactions in actual commodities and . . . transactions in commodity options.' '[T]ransactions *in* foreign currency' are indeed exempted from the Commission regulation. The exemption does not cover transactions involving the sale of foreign currency for future delivery conducted on a board of trade, since such transactions are specifically excepted from the exemption. Nor does the exemption cover options involving foreign currency, which are not "transactions in foreign currency" within the meaning of the Act.

Id. at 1183 (footnote omitted).

The defendants were preliminarily enjoined:

> (a) from accepting money, securities, or property (or extending credit in lieu thereof) from any person in connection with the purchase or sale of any commodity option; (b) from soliciting and accepting orders for the purchase or sale of commodity options and from supervising persons so engaged, and (c) from refusing to produce for inspection by authorized representatives of the Commission records that Commission regulations require be kept.

Id. at 1178.

46. *Id.* at 1182-83.

47. HUD Report, *supra* note 5, at 54. A standby contract is an option contract which lasts for a given time period granting one party the option to deliver specified securities to a second party at an agreed upon price. Such a contract is arranged between individual parties and does not involve trading on an organized exchange. *See* FEDERAL RESERVE BOARD, *supra* note 32.

CFTC.[48] This interpretation is paralleled by SEC assertions that forward contracts are securities and, therefore, subject to SEC jurisdiction. CFTC officials have been unwilling to conclude that forward contracts are not leverage contracts.[49] In order for the CFTC to claim that GNMA forward contracts are within the CFTC's jurisdiction as "leverage contracts,"[50] despite the exclusionary provision of section 2(a)(1) of the Commodity Exchange Act,[51] the CFTC must argue that a transaction in a "leverage contract," like a transaction in an option, is a transaction separate from a transaction in the underlying security.[52]

IV. Problems in the GNMA Market; Possible Regulation of GNMAs and Other "Exempted Securities" Markets

Commencing in 1976, public perception of fraudulent practices promulgated in the GNMA marketplace developed as a result of certain practices by a small number of market participants. These practices include misrepresentations,[53] pyramiding schemes,[54] over-

---

48. CFTC (CCH) 920,467 CFTC Interpretive Letter No. 77-12, *Dealers in GNMA Certificates as a Board of Trade* (Aug. 17, 1977) 21,910. A leverage contract constitutes:

> A standardized agreement (also commonly known to the trade as a margin account, margin contract, or leverage account) calling for delivery of a commodity with payments against the total cost spread out over a period of time. Principal characteristics include: standard units and quality of a commodity and of terms and conditions of the contract; payment and maintenance of margin; close out by offset or delivery (after payment in full); and no right or interest in a specific lot of the commodity.

Commodity Futures Trading Commission, Glossary of Some Terms Commonly Used in the Futures Trading Industry 16 (1975).

49. *See* Report of the Advisory Committee on Market Instruments to the CFTC on "Recommended Policies on Futures, Forward and Leverage Contracts and Transactions" (July 16, 1976) at v-vi.

50. *See* note 48 *supra*.

51. 7 U.S.C. § 2 (1976).

52. Immediate-delivery transactions in mortgage-backed securities have not been and are not likely to be significant sources of regulatory concern.

53. Among the misrepresentations which have occurred in the Ginnie Mae market, the following have been reported:

> (1) You'll never have to pay for these securities. You'll sell at a guaranteed profit before delivery is due. (2) The market is going straight up. You can't lose money on them. (3) Don't worry about funds for delivery. If you don't have enough, we'll arrange financing for you, and you'll even make a profit on that. (4) This pool pays down twice as fast as usual. At this price, your yield should be 50% higher than standard.

HUD Report, *supra* note 5, at 83.

speculation[55] and adjusted trading.[56] Public attention focused on the industry, and the resultant litigation, which highlighted the inadequacy of the existing legislation, raised some novel issues. In *Bache Halsey Stuart, Inc. v. Affiliated Mortgage Investments*,[57] the defendant alleged that GNMA forward contracts are separate securities requiring registration under the 1933 Act.[58] The defendant's underlying rationale was that if Ginnie Mae forward contracts are not futures subject to CFTC jurisdiction, then such contracts themselves constitute securities, separate from the securities to which they relate. Thus, such forward contracts would not be entitled to Ginnie Mae's exemption from the regulatory provisions of federal securities law. The court in rejecting this argument held that a delayed-delivery contract in GNMA securities is a contract to sell a security and not separate securities within the meaning of the Securities Act of 1933.[59] In noting that the defendants failed to show that registration would reduce any of the possibilities for speculation, the court also observed that registration would not change the risk incurred as a result of fluctuating interest rates. The court further concluded that the plaintiffs had clearly shown that the registration process would impose a severe burden on the issuers of GNMA certificates and that the impact of such a requirement would be felt throughout the industry.[60] Thus, this decision recognizes the formidable problems that would be involved in attempting to apply the registration provision of the 1933 Act to a forward contract.[61]

In *SEC v. Winters Government Securities Corporation*

---

54. Pyramiding is the practice of obtaining credit to finance a securities holding which can in turn be financed to purchase more securities. *Id.* at 90.

55. Overspeculation in GNMA securities refers to the purchase of GNMA securities with very limited equity in order to speculate on interest rates. *Report to the Executive Committee of the GNMA Mortgage-Backed Securities Dealers Association*, July 26, 1977 at 2.

56. Adjusted trading refers to the simultaneous purchase and sale of securities above the market price in order to avoid realization of a loss in another transaction. HUD Report, *supra* note 5, at 93-94.

57. Bache Halsey Stuart, Inc. v. Affiliated Mortgage Investments, 445 F. Supp. 644 (N.D. Ga. 1977).

58. *Id.* at 646.

59. *Id.* at 646-47.

60. *Id.* at 647.

61. For example, there would be the problem of determining who was the "issuer" of the security.

("WGS"),[62] a registered and relatively small securities dealer located in Florida sold GNMA's to relatively unsophisticated, small institutional investors through the use of unscrupulous and overly aggressive tactics. The SEC charged that WGS oversold Ginnie Maes to small institutions; WGS did not assure the suitability of the investments made by its customers or that such investments were within the financial capacity of an institution to honor when due. The abuses alleged by the SEC included: (1) "churning;"[63] (2) unauthorized transactions for certain customers; (3) misrepresentations about Ginnie Maes; (4) sham accounts (which were opened at the urging of salesmen); and (5) the inappropriate use of reverse repurchase agreements[64] as a financing technique. When the market price of Ginnie Maes declined due to a general increase in interest rates, "automatic" profits previously taken by WGS's customers became huge "paper losses." As a result, some customers disavowed trades, refused delivery, or claimed that the transactions were unauthorized. WGS was forced to pay forward contracts, but the SEC took decisive action against WGS under the anti-fraud provisions of the securities law.[65]

In the University of Houston investment fraud case,[66] a low eschelon investment officer of the University made large forward commitments in Ginnie Maes for the account of the University under inadequate supervision. Relying without caution on the expected financial state of this large and prestigious University, several prominent Ginnie Mae dealers handled the transactions with

62. No. 77-6345 (S.D. Fla., filed Aug. 15, 1977). This case involves trading abuse occurring only in the GNMA forward market.

63. This is the practice of making repeated purchase and sale transactions for the purpose of earning commissions or markups. *See* HUD Report, *supra* note 5, at 74.

64. Reverse repurchase agreements are the purchase of securities by a dealer under a contract in which the *purchaser* makes a commitment to sell back an equivalent amount of the securities at a specified price on a specified date, whereas repurchase agreements represent the sale of securities in connection with which the *seller* makes such a commitment. *Id.* at 216. *See also* note 109 *infra*.

65. WGS was forced to close its doors when its customers failed to pay for about $6 million of government securities they bought through the firm. *See* "SEC Says Firm Used Illegal Acts," Wall St. J., Aug. 16, 1977 at 12, at col. 1. Further, WGS was indebted to three New York based government securities firms for $1.5 million. *See* "Debt-Ridden Ginnie Mae Dealer Closes, Leaving Trail of Regulatory Questions," Wall St. J., May 17, 1977, at 15, col. 1.

66. *See* Plaintiff's original petition, State v. Covington Knox, Inc., No. 78-19222 (D. Tex., May 12, 1978).

the institution. The University had contracts in Ginnie Maes (both forwards and futures) amounting to several millions of dollars. Many transactions were financed by pyramiding or matched repurchase agreements.[67] However, due to rising interest rates which depressed the price of Ginnie Maes, this financing scheme collapsed when forward commitments could no longer be funded by previously purchased securities. The resultant loss was estimated at greater than $17 million.[68]

These widely publicized cases led to major changes in the conduct of Ginnie Mae dealers. Also, the publicity given to such incidents of abuse caused federal and state regulators to investigate rules and procedures designed to eliminate inappropriate investment and speculation in the Ginnie Mae market. Regulatory responses were promulgated by the Comptroller of the Currency (national banks),[69] the National Credit Union Administration[70] (credit unions), the Federal Home Loan Bank Board[71] (savings and loan associations), the Federal Reserve Board[72] (state member banks), and the Federal Deposit Insurance Corporation[73] (insured non-

67. When informed that the University lacked sufficient funds to pay for proposed forward contracts, in some instances the dealers offered to arrange immediate financing upon delivery so that the University could make the purchase. *See* HUD Report, *supra* note 5, at 76.

68. At one point, the University had made forward commitments in excess of $500 million although its available funds were a small fraction of that amount. *Id.* at 77.

69. Ginnie Maes are exempt from the registration requirements of the regulations of the Comptroller of the Currency. 12 C.F.R. § 16 (1980). *See* Letter from Owen Carney dated September 7, 1978, contained in HUD Report, *supra* note 5, Appendix III. B. at 219-22.

70. Federal credit unions are expressly authorized to invest in mortgage-backed securities by § 8(8) of the Federal Credit Union Act. Pub. L. No. 86-354, 66 Stat. 70 (codified at 12 U.S.C. § 1757 (1976)). *See* letter from John L. Ostby, dated October 30, 1978 in HUD Report, *supra* note 5, Appendix III. F. at 142-50.

71. Federal savings and loan associations may invest in mortgage-backed securities, however, such securities may not be included as "liquid assets" for the purposes of regulations adopted by the Federal Home Loan Bank Board. 12 C.F.R. § 545.9(c) (1980). *See* letter from John P. Valek dated October 5, 1978 in the HUD Report, *supra* note 5, Appendix III. E. at 235-42.

72. By letter dated June 1, 1970 to Woodward Kingman, President of GNMA, the Board of Governors of the Federal Reserve System ruled that member banks could invest in mortgage-backed securities and that such securities would be eligible as collateral for advances by the Reserve Bank. 12 C.F.R. § 201.108 (1980); 1968 Fed. Res. Bull. 1012. *See* letter from Robert S. Plotkin dated September 1, 1978 in HUD Report, *supra* note 5, Appendix III. C. at 223-25.

73. Most State Regulatory Authorities have expressed opinions that banks and insurance companies under their jurisdiction, may invest in mortgage-backed securities. These

member state banks), proposing rules relating to trading in GNMA securities by their constituents.[74] Such "back door" regulation is significant in alleviating problems in the industry.[75]

V. Initial Regulatory Efforts

Recognizing the lack of standards governing sales, the GNMA dealer community took steps to create a self-regulatory body in an attempt to address this deficiency. An industry organization, the GNMA Mortgage-Backed Securities Dealers Association (the "Association"), now the Mortgage-Backed Securities Dealers Association, began serious efforts at self-regulation. In a report dated July 26, 1977, the Rules Committee of the Association[76] recognized the problems existing in the GNMA market and suggested the following alternatives. The Rules Committee called for a determination of the regulatory power of the GNMA from the Department of Justice or HUD.[77] If it was determined that GNMA's power was inadequate to regulate the dealers in the market, the Rules Committee felt that legislation to authorize and direct GNMA to regulate the activities of the GNMA securities issuers and dealers should be enacted. Further, the Rules Committee suggested that the activities of the association be expanded.[78]

Ginnie Mae itself recognized the seriousness of an emerging problem of abuse in the GNMA marketplace and the necessity of corrective measures. The 1978 Annual Report of the Government National Mortgage Association pointed out: "A problem of continuing concern . . . has been the reports of occasional trading abuses, especially in the unregulated forward delivery markets for GNMA securities."[79] The Association's self-regulatory proposals have been evolving since November 1978 and have led to the re-

---

opinions are available in the GNMA Washington offices. *See* letter from John J. McCarthy dated August 28, 1978 in the HUD Report, *supra* note 5, Appendix III. D. at 226-34.

74. For example, such agencies have proposed rules relating to record-keeping of acceptable transactions and prohibitions on speculation intended to protect their constituencies.

75. In addition, several securities firms have independently adopted margin requirements for GNMA trades for certain customers.

76. GNMA Mortgage-Backed Securities Dealers Association Rules Committee, Report to the Executive Committee, July 26, 1977.

77. *Id.* at 11-13. The Association noted that the hazards of this proposal were that GNMA would not be an effective regulator or might not be responsive to industry needs.

78. *Id.* at 14-17.

79. Government National Mortgage Association, Annual Report 1978.

cently enacted rule amendments.[80] During this period, the following proposals have been submitted to the Justice Department for review: (1) membership for all dealers in mortgage-backed securities and those interested in such, including mortgage bankers; (2) a board of directors which represents the interests of large and small dealers, mortgage bankers and other interested parties, such as savings and loan associations; (3) a Code of Fair Practice prohibiting the types of abuses which have caused problems in the industry, such as misrepresentations and adjusted trading, and imposing a suitability and supervision requirement on all dealers, as well as requiring dealers to determine the credit worthiness of their customers; (4) market-to-market maintenance for all delayed-delivery contracts in excess of 150 days (formerly 120 days); (5) uniform confirmation, delivery and clearance procedures; (6) book and record-keeping requirements and audit procedures; (7) arbitration of inter-member and member-customer disputes; and, (8) formal disciplinary proceedings against members alleged to have violated the Association's rules and regulations.[81]

The Justice Department responding[82] to these proposals approved the Association's self-regulatory proposal in principle, but objected to the "market maintenance" rule which would have required members to impose uniform minimum margin requirements on their customers in certain transactions.[83] The Justice Department indicated that this rule could be viewed as an agreement by

80. 45 Fed. Reg. 116 (1980) (to be codified at 24 C.F.R. § 390). Section 390. 52 effective September 11, 1980; all other sections effective July 14, 1980.

81. *Id.*

82. The Department of Justice response to the proposed self-regulatory rules is contained in a letter from Donald L. Flexner, Acting Assistant Attorney General (Antitrust Division) to Victor S. Friedman, Counsel for the Mortgage-Backed Securities Dealers Association (June 25, 1979).

83. The uniform minimum margin rule would require a member entering into a contract of sale for mortgage-backed securities in which the settlement date is more than four months after the contract date to deposit along with the customer collateral equal to 100 percent of the adverse changes in the values of the securities from trade date to settlement. To be precise, the market maintanence rule would apply to contracts calling for settlement "later than the last day of the calendar month in which the 120th day after trade date falls. . . ." The market maintenance requirement is desirable according to industry members and regulatory agencies "because it would impress upon investors the more speculative nature of contracts which call for settlement beyond 120 days, and because it would reduce the prospect that the parties to the contract would not be able to make good delivery on the settlement date." *Id.* at 3-4.

Association members to impose the same margin requirement on all parties to the contract of sale for the securities regardless of their creditworthiness and credit needs.[84]

In 1978, coincident with the Association's self-regulatory proposal, the Department of Housing and Urban Development commissioned a private study,[85] "to examine the entire market for the trading of Ginnie Maes and to render a report on problems and potential problems, as well as to recommend a regulatory structure which would be effective in preventing abuses while accommodating legitimate trading practices."[86] The final report, issued in November 1978, revealed extensive details about the GNMA marketplace and the market participants, as well as its economics and legal and regulatory status. The HUD Report concluded that "GNMA support the present efforts at dealer self-regulation and that it announce its willingness to endorse a self-regulatory organization that meets the criteria we have outlined, in preference to any of the proposals for supervision by an existing or newly created government agency."[87] Thus, the HUD Report maintained that GNMA should oppose regulation of the GNMA dealers by the SEC or CFTC. The report recommended that any self-regulatory organization in the GNMA industry should have certain characteristics, including: (1) jurisdiction over all GNMA instruments other than those already regulated by another entity (*e.g.* CFTC); (2) open membership to all GNMA dealers; (3) a representative board of directors; (4) a staff headed by a full-time employee of the organization; and, (5) written rules of procedure governing arbitration and disciplinary functions.[88] The report further advised that GNMA should expand its "prudent business practices" guidelines to establish specific rules governing the relationship of issuers' forward commitments to actual and anticipated mortgage lending vol-

84. *Id.* It is fair to conclude that the Justice Department would have significant concern if the Association attempted to impose uniform substantive requirements on members and indirectly to impose those requirements on non-members.

85. HUD Report, *supra* note 5. It should be noted that GNMA is a government corporation within HUD, created to administer mortgage support programs which could not be carried out in the private market.

86. *Id.* at ix.

87. *Id.* at 180-83.

88. *Id.* at 130-33.

ume.[89] The HUD Report also advocated that GNMA educate and encourage federal and state regulators of participants in the GNMA market (such as the Federal Home Bank Board and the National Credit Union) so as to better regulate the GNMA activities of their constituencies.[90] The study further recommended that GNMA continue to support industry self-regulatory efforts and endorse any self-regulatory plan which contains certain minimum elements. Further, the report urged GNMA to oppose any proposals for federal legislation until adequate time has passed to enable assessment of the effectiveness of self-regulation. The report additionally recommended that "GNMA should also oppose any legislative initiative to subject the Ginnie Mae cash forward market to new federal oversight before there has been an opportunity for a meaningful test of self-regulation."[91] Finally, the HUD report predicted that "the basic elements of a scheme of unsupervised self-regulation could be in place within six to nine months and that such a plan could be implemented more rapidly than legislative alternatives"[92] and if self-regulatory efforts do not succeed, a regulatory agency, modeled on the Municipal Securities Rule-Making Board ("MSRB") could be the best regulatory approach.[93]

Industry efforts toward self-regulation sponsored initially by the Association as previously discussed, were revitalized by the Public Securities Association ("PSA") through the creation of PSA-Self-Regulatory Inc. ("PSA-SRI").[94]

PSA-SRI functions as a rule making entity which proposes requirements relating to mortgage-backed securities and govern-

---

89. *Id.* at 183.

90. *Id.* at 177-78.

91. *Id.* at 181.

92. *Id.* at 184.

93. *Id.* at 193-95. *See also* Dikeman, *Municipal Securities Rulemaking Board: A New Concept of Self-Regulation*, 29 VAND. L. REV. 903 (1976); Wallison, *Self-Regulation of the Municipal Securities Industry*, 6 SEC. REG. L.J. (1979); Comment, *Federal Regulation of Municipal Securities: A Constitutional and Statutory Analysis*, DUKE L.J. 1261, 1310-19 (1976).

94. 126 CONG. REC. S3347 (daily ed. Apr. 1, 1980). The PSA is a national trade association representing banks, dealers, and brokers that underwrite, trade, and sell U.S. government and federal agency securities. According to its most recent 1979 Annual Report, the Association approved the formation of an affiliate organization, PSA-SRI, to establish and promote standards of conduct for its members who participate in the market for government mortgage-backed securities.

ment-guaranteed securities. PSA-SRI has published proposed rules substantially similar to those of the Association and has become the entity responsible for implementing industry-sponsored self-regulation in the GNMA industry.[95] It has been pointed out that the PSA-SRI (and Association) rules were drafted with the objective of avoiding antitrust problems.[96] The rules do not contain inducements to membership which would assure that the class of nonmembers would be negligible. The antitrust concerns are addressed in the following manner: (1) the critical rule regarding audit procedures, suitability, supervision, risk disclosure and financial responsibility do not apply to nonmembers; (2) the rules do not require that the records and procedures adopted by members be uniform; (3) the rules do not establish standards by which the reasonableness of such records and procedures could be judged; (4) PSA-SRI has not established a systematic inspection program to monitor compliance with the rules of any records or procedures adopted by the members under the rules.

In addition to the delays in the industry regulatory efforts, the need was recognized for serious consideration of the Justice Department decision that although the regulations proposed by the industry are compatible with the antitrust laws, the imposition of uniform margin requirements by a private self-regulatory organization would raise serious questions under the Sherman Act.[97] GNMA has also recognized the problems inherent in self-regulatory efforts.[98] The Executive Vice President of GNMA indicated that GNMA has grown "impatient" with industry self-regulatory efforts. GNMA cited as problems with the program, the lack of margin rules and the need to persuade all GNMA dealers to abide by the rules.[99] GNMA further indicated that it saw no role for

95. PSA-SRI has recruited members and a code of conduct has been developed with the cooperation, but not the approval of federal agencies. Presently, PSA-SRI has approximately thirty members, primarily broker-dealers. Despite some early confusion about the respective roles of the Association and PSA-SRI, PSA-SRI has assumed the rulemaking and rule enforcement role in the industry, although the Association continues to exist.

96. 126 CONG. REC. S3347-48 (daily ed. Apr. 1, 1980).

97. *See* letter from Donald L. Flexner, Acting Assistant Attorney General (Antitrust Division), to Victor S. Friedman, Esq., Counsel for the Mortgage-Backed Securities Dealers Association, (June 25, 1979).

98. *See* letter from Fred Taylor to Harrison Williams, Jr., United States Senator (Aug. 31, 1979).

99. *See* letter from Fred Taylor to Roger P. Shay, Chairman PSA Self Regulation, Inc.

GNMA as part of HUD to regulate trading in Ginnie Maes; HUD's role is only to administer the issuance of Ginnie Maes. It has been acknowledged that there must be regulation of trading in mortgage-backed securities and that the SEC is the appropriate regulatory body.[100]

Further acknowledging the need for an SEC response, on April 17, 1979, Senator Harrison Williams requested SEC assistance in determining the need for and the framework of possible additional legislation to regulate dealers in GNMA securities and other federal government-guaranteed securities.[101] In his response to Senator Williams, SEC Chairman Williams acknowledged the need for some regulation of the market.[102] He stated that the system created for the regulation of municipal securities professionals, including a self-regulatory organization with primary rule-making authority, suggested itself as a model for the regulation of the market for mortgage-backed securities. Further, Chairman Williams referred in his letter to an increasing number of abuses in the mortgage-backed securities market and cited several SEC investigations.[103] Chairman Williams indicated that many of the practices in these cases were comparable to those which were present in the

(Aug. 15, 1979).

100. *Id.*

101. *See* letter from Harrison A. Williams, Jr., United States Senator to Harold M. Williams, Chairman, Securities & Exchange Comm'n (Apr. 17, 1979).

102. *See* letter from Harold M. Williams, Chairman Securities & Exchange Comm'n to Harrison A. Williams, Jr., United States Senator (July 9, 1979).

103. *See* Securities & Exchange Comm'n v. Trans-American Gov't Sec., Inc., No. 79-2163 (W.D. Tenn. Mar. 9, 1979) (involving adjusted trading); Securities & Exchange Comm'n v. Harwell, No. 78-1916 (S.D. Texas Oct. 5, 1978) (the so-called "University of Houston" case, involving interpositioning, pyramiding, and excessive fees); Securities & Exchange Comm'n v. Fidelity Sec., Inc., No. 78-2410 (W.D. Tenn. Aug. 15, 1978) (involving adjusted trading, which is the simultaneous sale and purchase of different securities above the market price in order to avoid a loss in the security being sold, and excessive fees); Securities & Exchange Comm'n v. American Bankshares Corp., No. 77-750 (E.D. Wisc. Nov. 21, 1977) (involving adjusted trading and resultant false financial statements); In the Matter of First Nat'l Bank of Chicago Bond, File No. 3-5316 (Nov. 10, 1977) (the companion case to *American Bankshares* above); Securities & Exchange Comm'n v. Financial Corp., No. 75-3391 (S.D.N.Y., July 9, 1975) (involving inability to meet obligations of repurchase agreements); Securities & Exchange Comm'n v. Russell, Kennedy and Hodgen, Inc., No. 77-1080 (S.D. Texas July 8, 1977) (involving Ponzi-like schemes using repurchase agreements); In the Matter of Michael J. Kratze, File No. 3-5231 (May 24, 1977) (involving interpositioning); and In the Matter of Merrill, Lynch, Pierce, Fenner & Smith, Inc., Sec. Ex. Act Rel. No. 11515 (July 2, 1975) (involving unsuitability).

municipal securities market and which led to regulation of that market.[104] Chairman Williams also alluded to the fact that any legislative solution should recognize that the jurisdiction of the SEC and the CFTC currently overlap in a manner which has the potential for impeding effective regulation. Chairman Williams' view is that the regulatory and enforcement authority over trading of all futures based on securities should be integrated in one agency.

The SEC also is attempting to expand its jurisdiction over various GNMA related instruments. According to Chairman Williams,[105] the SEC maintains that standby and forward contracts for mortgage-backed securities are securities subject to the SEC's existing jurisdiction.[106] Moreover, in a recent release,[107] the SEC announced a general statement of policy with regard to the legal implications under the Investment Company Act of 1940[108] of forward contracts, reverse repurchase agreements[109] and standby commitments[110] entered into by registered investment companies. The release indicated that such devices might be deemed securities

104. *See* Securities Acts Amendments of 1975, SENATE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, S. REP. No. 75, 94th Cong., 1st Sess. 43 (1975). In the absence of industry initiative suggesting another pattern of regulation, it is most likely that federal legislation will authorize SEC regulation of the area. *See also* Note, *Municipal Bonds and the Federal Securities Laws: The Result of Forty Years of Indirect Regulation*, 23 VAND. L. REV. 561, 582-86 (1975).

105. *See* note 101 *supra*.

106. *See* notes 28-29 *supra*.

107. "Securities Trading Practices of Registered Investment Cos.," 44 Fed. Reg. 25,128-34 (1979) (to be codified at 17 C.F.R. § 271 (1980)).

108. 15 U.S.C. § 80 (1976).

109. In a reverse repurchase agreement, the investment company borrows money; in a repurchase agreement, the investment company lends money. 44 Fed. Reg. 25,129 n.2. In a typical investment company reverse repurchase agreement, an investment company is the record owner of a Ginnie Mae. The investment company transfers possession of the Ginnie Mae to another party (often a broker/dealer or a bank) in return for a percentage of the value of the Ginnie Mae, usually 90-97% of its market value, but retains record ownership and the right to receive interest and principal payments on the Ginnie Mae. At an agreed-upon future date, the investment company repurchases the Ginnie Mae so transferred by remitting the proceeds plus interest. 44 Fed. Reg. 25,129 (1979).

110. The standby commitment agreement is a delayed delivery agreement in which the investment company contractually binds itself to accept delivery of a Ginnie Mae with a stated price and fixed yield upon the exercise of an option held by the other party to the agreement at a stated future date. The investment company receives an individually negotiated, non-refundable commitment fee in consideration for its agreement to "standby" to purchase the Ginnie Mae. *Id.* at 25,131.

under the 1940 Act.[111] This would appear to open the door to similar assertions in other situations.[112]

VI. The Williams Bill

A comprehensive governmental regulatory pattern requires legislation. Thus, on April 1, 1980, Senator Harrison Williams, introduced legislation "to amend the Securities Exchange Act of 1934 and for other purposes."[113] Senator Williams' bill represents an artful compromise.[114] The Government-Guaranteed Securities Acts Amendments of 1980, ("Williams bill") is intended to perform three functions. First, the bill would "amend the Federal securities laws to require the registration of brokers and dealers in certain Government guaranteed securities with, and permit their regulation by, the Securities and Exchange Commission and the bank regulatory agencies."[115] Second, the Williams bill would "establish the Government Securities Rulemaking Board ("GSRB"), a seven-member self-regulatory organization to exercise primary rule-making authority with respect to such dealers to promote just and eq-

111. The SEC focused on certain trading practices engaged in by open-end investment companies, generally known as the reverse repurchase agreement, the firm commitment, and the standby commitment agreement. Such practices raised serious questions as to whether they involved the issuance of senior securities by the investment companies, and thus, are either prohibited by, or subject to the asset coverage requirement of section 18(f)(1) of the Investment Company Act of 1940, 15 U.S.C. § 80a-18(f)(1) (1976). This section provides, in part, that it shall be unlawful for any registered open-end investment company to issue any class of senior security of which it is the issuer, except that the investment company shall be permitted to borrow from any bank, provided that immediately after any such borrowing there shall be an asset coverage of at least 300 per centum for all borrowings of the investment company as computed under section 18(h) of the Act. 15 U.S.C. § 80a-18(h) (1976). These practices may have similar effects on closed-end investment companies, which are also subject to restrictions on their capital structure under section 18. For example, section 18(a) of the Act, 15 U.S.C. § 80a-18(a) (1976), makes it unlawful for a closed-end investment company to issue senior securities unless asset coverage and other requirements are met.

112. One may contrast the Commission's *amicus* brief in Securities & Exchange Comm'n v. Winters Government Securities Corp. (S.D. Fla., Civ. Action. No. 77-6345). In arguing against CFTC jurisdiction over the case, the Commission argued that delayed delivery contracts are not futures contracts. This discussion implied that in the Commission's view a delayed delivery contract is not an instrument apart from the sale of the GNMAs, and thus is not a separate security.

113. *See* note 101 *supra*.

114. S 2512, 96th Cong., 2d Sess. (1980).

115. 126 CONG. REC. S 3346 (daily ed. Apr. 1, 1980). However, the Williams bill was widely feared by the industry for the wide latitude accorded the SEC.

uitable principles of trade and ethical business practices."[116] Third, this legislation would "encourage the creation of a centralized clearing facility open to all participants in this marketplace."[117] Senator Williams acknowledges the industry-wide concerns about government intervention, recognizing both that the federal government lacks the expertise to oversee this market, and that there is a legitimate fear of interference with the "national operations" of the market and of inappropriate expansion of the federal government. However, federal regulation of the dealer community remains the sole solution in light of the present need to "restore a high degree of integrity, professionalism, and investor confidence to this marketplace and to protect the financial interest of the federal government in both its guarantee and its ability to market successfully its securities."[118]

In considering the Williams bill, the interrelation between the GSRB and the SEC must be examined. The Williams bill proposes

---

116. S 2512, 96th Cong. 2d Sess. at 13-22 (1980). Senator Williams outlines three categories of dealers in government-guaranteed securities for the purposes of his legislation:

> First, dealers who engage in a full line of securities activities; second, dealers who trade only in U.S. Government securities, and who may be subsidiaries or affiliates of firms engaged in other securities activities, and third, banks.

117. *Id.* at 34-35. The initial Board members would be appointed by the SEC after consultation with the Treasury, the FDIC, the Comptroller of the Currency and the President of GNMA to serve for two years and adopt rules governing their succession.

According to the background of this bill, a partial list of the areas subject to the GSRB's regulation would include (1) prevention of fraudulent and manipulative acts and practices and protection of just and equitable principles of trade; (2) establishment of standards for entry into the public securities business; (3) fair dealings with investors; (4) regulation of selling and under writing practices; (5) creation of procedures for arbitration of intra-industry disputes; (6) determination of the frequency and scope of intra-industry disputes; (7) and determination of the frequency and scope of inspection of public securities dealers by the bank regulatory authorities with respect to banks, and the National Association of Securities Dealers with respect to securities firms; and (8) suitability, markup, excessive transactions authorization and acceptance of accounts. *Id.*

118. *Id.* at 45-49. As defined in the Securities Exchange Act of 1934, the term "clearing agency" means any person who acts as an intermediary in making payments or deliveries or both in connection with securities transactions or who provides facilities for comparing data respecting the terms of settlement of securities transactions. Under the existing law, there is no statutory mandate to either encourage movement toward a centralized clearing agency for government-guaranteed securities or to empower the SEC or any other agency of government to regulate such a facility. The Williams bill proposes to expand the SEC's authority under § 17A of the Exchange Act to facilitate the development of a national system of clearance and settlement for transactions in government-guaranteed securities. The need for a central clearing house in this market has been also suggested by PSA and many individual firms. 126 CONG. REC. S 3352 (daily ed. Apr. 1, 1980).

to require and empower the Commission to review GSRB proposed rules to discharge its duties "to insure that the [GSRB's] rules are in conformity with the public interest and applicable statutory standards."[119] However, the Commission would not have the authority to alter or supplement the existing rules of the GSRB.[120] The Commission is vested with certain "police powers" to the extent of "censuring any member or employee of the Board who had willfully violated any provision of the Act, the rules thereunder, or rules of the Board, or had willfully abused his authority."[121]

In several significant ways, the Williams bill departs from the existing treatment of the Multiple Securities Rulemaking Board ("MSRB")[122] and the municipal securities market under the 1934 Act. First, in conformity with present law, the Williams bill consolidates the statutory treatment of business organizations that may be engaged in several securities activities, including municipal as well as Government securities. Further, concerning GSRB's deliberations, the Williams bill would require that prior to filing a proposed rule with the SEC, the GSRB would be required to request and consider the views of the Treasury Department and any other Government agency that issues or guarantees such securities.[123] Finally, the Williams bill would expressly permit national securities exchanges to administer and enforce against their members the rules of the GSRB, subject to the SEC's authority to allocate these functions among the various exchanges and the NASD. Moreover, in recognition of the special interest of the Secretary of the Treasury, the bill empowers the Secretary with the authority to designate the particular guaranteed securities to be subjected to the provisions of the Act that would be added by this bill.[124]

---

119. *Id.* at 3350.

120. S 2512, 96th Cong., 2d Sess. at 61-64 (1980).

121. In this respect, the SEC's general powers over the Board would be extensive but somewhat different than those the Commission has over the other self-regulatory organizations under the Exchange Act. *Id.*

122. "Creation of the MSRB was mandated by the Securities Acts amendments of 1975. These amendments were designed, in part, to regulate for the first time, dealers in municipal securities. The 1975 amendments had been enacted because many of the trading practices currently prevalent in the Ginnie Mae Market were occurring in the municipal securities market." Doron Bar-Levan, *Trading Abuses in Ginnie Maes*, 8 SEC. REG. L.J. No. 42, 67 n.113 (1980).

123. S2512, 96th Cong., 2d Sess. at 48 (1980).

124. *Id.* at 2. Another significant change from the present law is that these amendments

In contrast to the Williams bill, a joint regulatory study of the government securities markets undertaken by the Treasury, the Federal Reserve Board and the SEC[125] advanced the following scheme for government securities regulation: first, creation of the Federal Mortgage-Backed Securities Rulemaking Board ("FMBSRB"), a Municipal Securities Rulemaking Board-type agency which would be composed of industry officials and public representatives;[126] second, creation of an oversight council of three agency heads or their appointees which would possess approval powers over board rules (it was suggested that this authority be delegated to the SEC);[127] third, mandatory membership in the Securities Investor Protection Corp. for Ginnie Mae and Freddie Mac dealers;[128] and finally, SEC enforcement authority with reliance on the National Association of Securities Dealers, exchanges and bank regulators to conduct their own investigations.[129] While congressional interest in legislation regulating GNMAs is significant, the Senate Banking Committee staff has indicated a "strong willingness to conduct hearings this year on the Ginnie Mae bill proposed

---

would enable the Federal Reserve Board to establish appropriate margin requirements for transactions in government-guaranteed securities.

125. Federal Reserve Chairman Volcker was responding to Senator Williams' request for input in undertaking this study. A draft copy of this joint study's recommendations has been under study by the Office of Management and Budget and the Antitrust Division of the Justice Department since mid-June 1980. The information cited in this Note is derived from a summary of that draft copy published in *Securities Week* in a special issue dated September 24, 1980.

126. *Id.* The joint study's draft recommendations would require legislative action. Further, adherence to FMBSRB rules would be mandatory for dealers in GNMA-guaranteed securities and Federal Home Loan Mortgage Corp. ("FHLMC") obligations. Initially, the Board would have authority over no other aspects of the government market.

127. It has been suggested that this authority be delegated to the SEC. The council would have to gain GNMA and FHLMC input, although the two agencies would have no authority. Dealers would be required to register with the council, through the SEC initially.

128. The FHLMC ("Freddie Mac") created by Congress in 1970 and wholly owned by the Federal Home Loan Banks (FHLB's), has as its primary goal the development of a national secondary market in conventional mortgages. Generally, FHLMC purchases conventional mortgage loans from savings and loan associations (four-fifths of its total purchases), mutual savings banks, commerical banks, and mortgage banks.

At first, FHLMC purchased mainly participations and whole loans for its own portfolio, financing the acquisitions by borrowing from the Treasury, the FHLB's and by issuing its own mortgage-backed bonds. In 1974, however, the focus of its operation was shifted toward the sale of mortgage participation certificates (PC's) and guaranteed mortgage certificates (GMC's). 126 CONG. REC. S3346-47 (daily ed. Apr. 1, 1980).

129. Further, the SEC would have to consult with the council before instituting actions.

by Senator Williams with or without the tri-agency document.[130]

VII. Conclusion

As a result of the problems in the GNMA securities market, an amendment of section 15 of the 1934 Act to require registration of brokers and dealers selling mortgage-backed securities and/or other exempted securities constitutes a realistic goal in light of the proposed legislative amendment. Such an amendment would have significant impact if it required brokers and dealers who deal in now exempt securities to register and be subject to net capital requirements, including percent trimmings of 0.3% on government securities, book and records requirements, and segregation requirements. This would have broad implications for the government securities market, which has traditionally been free of direct government supervision. Additionally, there exists the possibility of special net capital cuts on forward commitments in government securities. Further, the enforcement of possible margin requirements (Regulation T)[131] on exempted securities or forward commitments in exempted securities would also require legislative action. A margin requirement on mandatory commitments or optional commitments could have a substantial effect on the GNMA commitment program. The passage of legislation requiring registration under the 1933 Act of presently exempted securities or forward commitments in exempted securities is unlikely; registration does not address the problems in the mortgage-backed securities market, but it cannot be totally ruled out. Finally, the issue of whether the dealer market in GNMA securities is a Board of Trade must be dealt with comprehensively.[132] If so, it is arguable that the CFTC could assert jurisdiction over transactions in GNMA forwards.

Janice L. D'Arrigo

---

130. *Securities Week*, Sept. 24, 1980, Special Issue.

131. Regulation T is the Federal Reserve Board's regulation governing the amount of credit that brokers and dealers may extend to customers who buy securities. HUD Report, *supra* note 5, at 216.

132. In a letter dated August 17, 1977, Richard E. Nathan (General Counsel of CFTC) discusses this issue but does not resolve it because of inadequate information. CFTC (CCH) 920,467, CFTC Interpretive Letter No. 77-12, "Dealers in GNMA Certificates as a Board of Trade," Aug. 17, 1977, 21,909-12.